



COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

September 6, 2019

The Honorable Ron Wyden  
Ranking Member  
Committee on Finance  
United States Senate  
Washington, DC 20510

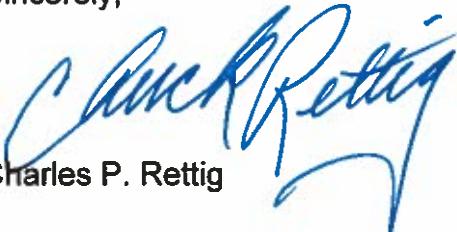
Dear Senator Wyden:

I write in response to a question you raised in my April 10, 2019, hearing in front of the Senate Finance Committee. You asked about recipients of the Earned Income Tax Credit (EITC) and why they may be more likely to be audited than taxpayers accounted for in the overall audit coverage rate.

The enclosed report explains the two different kinds of audits that IRS employees conduct. It also provides information about EITC audits and audits of high-income and high-wealth taxpayers and includes short- and long-term steps that the IRS and Congress can take together to ensure that we have appropriately balanced audit coverage across all income levels.

I hope this information is helpful. Since this will be part of the official hearing record, I am also sending the report to Senators Bennet and Cortez Masto, who submitted Questions for the Record on this topic, as well as to Chairman Grassley. If you have any additional questions, please feel free to contact me, or a member of your staff may contact Leonard Oursler, Director, Legislative Affairs, at 202-317-6985.

Sincerely,

  
Charles P. Rettig

Enclosure

## AUDITS

A key component in promoting the highest degree of voluntary compliance on the part of taxpayers is enforcement of the tax law. By pursuing those individuals and businesses who don't comply with their tax obligations, the IRS is being fair to those who are compliant. This helps promote public confidence in our tax system for all taxpayers.

The IRS enforces the tax law in a number of ways. The primary way is through the examination of tax returns that are identified as having the highest potential noncompliance. This identification is determined using risk-based scoring mechanisms, data driven algorithms, third party information, whistleblowers and information provided by the taxpayer. The objective of an examination is to determine if income, expenses and credits are being reported accurately.

### Types of Examinations

IRS employees conduct examinations or audits in one of two ways. The first is by mail and are called correspondence examinations. The second, called face-to-face examinations, take place in person at an IRS office or at the taxpayer's place of business. The complexity of the return determines whether the audit is by correspondence or in person. Certain individual non-business returns with low and medium adjusted gross income can be handled effectively by correspondence audit. All other returns selected for examination are better handled either as an in-IRS office examination or at the taxpayer's place of business.

### Correspondence Examinations

Correspondence examinations are performed at IRS campus locations by tax examiners, who are GS-5, 6, 7, or 8. The IRS currently employs 969 tax examiners conducting correspondence examinations of simple individual Form 1040 returns. Generally, the questionable issues are EITC, additional child tax credit, American opportunity tax credit, medical expenses, contributions, taxes, or employee business expenses. Tax examiners receive training on these issues but are not required to have accounting skills. An additional 144 tax examiners conduct correspondence examinations of non-resident alien returns (Form 1040NR) focusing generally on withholding.

Correspondence examinations are less burdensome for taxpayers than in-person audits as they mail in their documentation and don't have to travel in or take a day off from work to visit an IRS office. They are also the most efficient use of IRS' examination resources with a correspondence examination costing the IRS approximately \$150. In FY 2018, the IRS conducted 75% of examinations by correspondence.

### Face-to-Face Examinations

Tax Compliance Officers (TCOs), who are GS-7, 9, and 11, conduct face-to-face examinations in IRS offices (sometimes called an "office audit"). The IRS currently employs 572 TCOs. TCOs receive more training than tax examiners and have some accounting training. An audit by a TCO generally requires an in-office interview of the taxpayer but doesn't require an on-site inspection of the taxpayer's books, records, or assets. The types of issues selected for an office

audit are income from tips, pensions, annuities, rents, fellowships, scholarships, royalties, and income not subject to withholding; deductions for business related expenses; deductions for bad debts; determinations of basis of property; capital gain versus ordinary income determinations; and complex miscellaneous itemized deductions such as casualty and theft losses.

The most complex returns, which are certain individual, corporate, and partnership returns, are audited by a Revenue Agent (RA) at the taxpayer's place of business. Revenue Agents are our most highly trained and experienced employees with substantial accounting skills and are GS-9, 11, 12, 13, and 14. The IRS currently employs 6,463 RAs. Their skills are required due to the complex business transactions of the taxpayer, more voluminous records, and extensive time required to complete the audit. In addition, the issues involved in a RA audit may require assistance from a specialist, such as an engineer, economist, or appraiser. Since these are the most costly examinations conducted by the IRS, RAs are directed to the most egregious noncompliance areas. These include high income, high wealth taxpayers, cash intensive businesses, transfer pricing, executive compensation, research and development credits, cryptocurrencies, partnerships and flow through entities, micro captives, offshore transactions, and syndicated conservation easements.

### **Available Employee Resources**

The IRS has experienced significant attrition in examination resources since 2010. As the chart below demonstrates, IRS has lost 28% across its tax examiner, TCO, and RA population. As a result, audits have declined across all income levels.

<b>Position</b>	<b>FY 2010</b>	<b>FY 2019 (as of April)</b>
Revenue Agent	8553	6463
Tax Compliance Officer	1407	572
Tax Examiner	1151	969
<b>Total</b>	<b>11,111</b>	<b>8004</b>

### **Earned Income Tax Credit (EITC) Audits**

EITC is a refundable tax credit for certain people who work and have earned income. Audits of more rural, lower income taxpayers occur because these taxpayers are more likely to claim EITC. To claim the EITC, taxpayers must meet certain rules. These rules include that the taxpayer and qualifying children must have social security numbers by the due date of the return and qualifying children must meet the relationship, age, and residency tests. In addition, there are earned income limitations based on filing status. For tax year 2017, to qualify for the EITC earned income has to be below the following amounts:

<b>Qualifying Children</b>	<b>Single or Head of Household</b>	<b>Married, Filing Jointly</b>
3 or more	\$48,340	\$53,930
2	\$45,007	\$50,597
1	\$39,617	\$45,207
0	\$15,010	\$20,600

Over 26 million taxpayers receive over \$64 billion in EITC benefits. The National Research Program (NRP) estimates that approximately 50% of EITC claims have errors and the \$18.1 billion improper payments account for almost half of the \$40 billion portion of the tax gap attributable to credits.

In FY 2017, risk-based scoring identified about 6.4 million returns as claiming a potentially erroneous EITC due to a qualifying child issue or misreported income. As noted above, these are single issue correspondence audits worked out of IRS' campus locations. The selection criteria do not include any components or factors related to the geographic location (including mailing addresses) or ethnicity of taxpayers.

The following chart shows the number of EITC audits closed for last two fiscal years. It also shows the audit coverage rate. The IRS planned to audit approximately 300,000 EITC returns for over the past 5 years and plans to continue to audit about 300,000 returns each year in the future. EITC correspondence audits are the most efficient use of available IRS examination resources with the average time to complete the audit of 5 hours per return.

Fiscal Year	Audits Closed	Total EITC Returns Filed	Audit Coverage
FY 17	326,503	26.7 million	1.2%
FY 18	330,461	26.1 million	1.2%

#### High Income High Wealth Audits

While the IRS' Data Book Table 9b for 2018 shows the audit coverage rate by adjusted gross income groupings, the IRS actually groups taxpayers for applying audit resources by total positive income (TPI). TPI is the sum of all positive amounts shown for the various sources of income reported on the individual tax return and, therefore, excludes losses. By using TPI, higher income taxpayers that have losses, such as losses from flow through entities are not grouped in a lower AGI income class. Even with declining resources, audit coverage is greater in the larger TPI income grouping than coverage of EITC returns that fall in a lower TPI income range. The following chart shows audit closures and audit coverage for TPI of \$10 million for past 2 fiscal years. A taxpayer with AGI of \$10 million and over is included in the TPI of \$10 million and over grouping. The average time to complete these audits range from 61 hours to 251 hours per return.

Fiscal Year	Audits Closed	Total \$10 million and over returns filed	Audit coverage
FY 17	3,068	19,600	15.6%
FY 18	1,903	23,450	8.1%

## **Examination Plan**

The IRS cannot simply shift examination resources from single issue correspondence audits to more complex higher income audits because of employee experience and skillset. A GS-8 tax examiner is not trained to conduct a high income, high wealth taxpayer audit. In order to increase parity of numbers of taxpayers audited, the IRS must reallocate high-graded resources from certain issues to high income, high wealth taxpayer returns. Further, the rate of attrition is significantly higher among these more experienced examiners. It is also important to maintaining the voluntary compliance level that the IRS has an audit presence across all income groups, including EITC.

In the short-term, the IRS will continue to open additional audits in FY 2019 in the category of TPI of \$10 million and over. At the end of FY 18, the IRS had 5,220 audits open in this TPI grouping and through May of FY 19, the IRS had increased the number of audits open by 200 in this TPI grouping. In the longer-term, Congress must fund and the IRS must hire and train<sup>1</sup> appropriate numbers of RAs to have appropriately balanced coverage across all income levels.

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<sup>1</sup> An RA must be trained and on the job for at least 2-3 years in order to have the experience and expertise to audit a complex return.